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Editor's Notes

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In this Edition

Tony Martini's column in this edition includes an update on the proposed Section 6417 Regulations and the BABs litigation involving the Indiana Municipal Power Agency, as well as commentary on Private Letter Ruling 202306009.

Drew Kintzinger reports on the recent adoption by the SEC of cybersecurity disclosure requirements for public companies, the syndicated loan appellate decision, and recent enforcement actions, including another settlement in the Sterlington, Louisiana mater.

Some thoughts on *Kirschner v. JP Morgan Chase Bank, N.A* [1]

It has been interesting following the litigation involving of a trustee's quest to hold someone accountable for potential losses in bankruptcy relating to a $1.775 billion syndicated loan transaction. Scores of analyses and comments have been published and there was also a student note published in the *Colorado University Law Review*. The repercussions in the United States syndicated loan market (estimated by some to be $2.3 trillion) might have been monumental if the trustee had prevailed in his argument that the syndicated loan in question was, in fact, a "security." During the hearing on appeal in March 2023, the 2nd Circuit panel pondered whether the SEC would offer its views on the matter. The SEC demurred, after two requests for a time extension to file a brief, stating "despite the best efforts to respond to the court's request, the Staff was not in a position to file a brief on behalf of the Commission." It is important to note this case is not a federal securities law case. The plaintiff filed in New York state court with state-law-based securities fraud claims, among others. The case was removed to federal court upon the defendant's motion claiming jurisdiction under the Edge Act[2]. Certain aspects of the case depended upon whether the loan was a security for state law

[1] Kirschner v JP Morgan Chase Bank, N.A., et al, 79 F.4th 290 United States Court of Appeals, Second Circuit
[2] 12 U.S.C. § 632. The Edge Act provides for federal jurisdiction over matters concerning certain international banking entities. This is not relevant to the loan vs. security analysis but it allowed the defendants to move the proceedings from state court.

purposes and, absent specific state law interpretation on the subject, the plaintiff asserted the federal law analysis found in *Reves v Ersnt & Young*[3] should be applied.

The facts of the case, depending on whose brief you read, are compelling (a tip of the hat to the legal drafters). According to the pleadings, the plaintiff-appellant is the appointed trustee for "approximately 70 institutional investor groups, comprising roughly 400 mutual funds, hedge funds, and other institutional investors."[4] The defendant-appellees include the veritable "Who's Who" in commercial banking. The plaintiff alleged the defendants fraudulently or negligently offered and/or distributed interests in the syndicated loan while knowing (or failing to conduct sufficient diligence to know) the borrower was teetering on disaster because of ongoing litigation and investigations. Defendants, on the other hand, argued successfully that in this syndicated loan transaction each lender was required to, essentially, fend for itself, conduct its own diligence, make its own credit decision, and not rely on any statements made by the "arrangers" of the loan. In other words, the participating lenders were required to act like lenders in a traditional commercial banking role. Significant in the court's analysis were numerous disclaimers included in the loan documentation.

In the District Court proceedings, the Defendants prevailed on a motion to dismiss under rule 12(b)(6) (remember that from law school civil procedure class?) wherein, among other determinations, the District Court applied the *Reves* analysis and determined the loan was not a security. The Plaintiff moved for leave to file an amended complaint; however, that motion was ultimately denied on grounds of "futility." Plaintiff appealed to the 2nd Circuit and that court reviewed the matter "*de novo*."

The structure of this loan syndication was fairly typical. The group of lead lenders (or arrangers) committed to the $1.775 billion loan on the basis of commitments from sub-lenders (referred to as "Parent Investors"). Those sub-lenders, in turn, had commitments from yet more lenders (the so-called "Child Investors"). All told there appear to have been more than 400 lenders in the transaction. The transaction was documented with a Credit Agreement and there was a confidential information statement describing the loan, the terms of the commitments, the conditions to lending, and many disclaimers. The Credit Agreement permitted the participating lenders to assign and transfer their interests, subject to certain conditions, including, among others, consent by the lead arranger as administrative agent, a minimum transfer amount ($1 million)[5] and a prohibition on transferring an interest to "a natural person." The court described those transfer provisions as facilitating "the creation of a secondary market" for the debt instrument; however, it rejected the Plaintiff's argument that the existence of an active secondary market was dispositive of the loan being a security. There were a few stray references to "investors" in the documents, including a reference to "Public

[3] *Reves v. Ernst & Young,* 494 U.S. 56 (1990).
[4] See Plaintiffs brief on appeal.
[5] The Plaintiff argued it was "only" a million dollars.

Side Investors" on the cover of the confidential information statement and an "Investor Presentation"; however, the court did not find that convincing and concluded those isolated references to "investors" could not have created a reasonable expectation that the credit arrangement was a security rather than a loan.

Are there takeaways in *Kirschner* for the municipal market? Yes and No.

The good news is that there really is nothing new here. The key takeaway is confirmation that the *Reves* analysis is still alive and well for purposes of the "loan vs security" analysis. Additionally, the 2nd Circuit confirmed the intent of the purchaser/buyer and issuer/seller plays a key, if not paramount, role in the analysis. The not-so-enlightening aspect of this opinion concerning the *Reves* analysis is the distinction between commercial and investment motivation[6]. It is difficult to analogize the *Kirschner* opinion discussion on this point to the municipal market. The court made a distinction in the borrower's intent by virtue of the fact the purpose of the borrowing was to refinance debt and pay dividends, noting this was "commercial" in nature. The court contrasted this motivation to a debt transaction to raise funds to invest in the borrower's business operations. The lender's interest was determined to be "investment" by virtue of the expectation of a "valuable return" in the form of quarterly interest payments. This might suggest that all lenders have an investment interest in all interest-paying debt obligations, but the borrower's intention turns on the purpose of the financing. Given the capital nature of most traditional municipal transactions and the public-services orientation of municipal entities, this distinction is not easily translatable to municipal debt.

The court's discussion of the plan of distribution under the *Reves* analysis is somewhat relatable to the municipal market. As noted in Drew Kintzinger's column in this edition, the 2nd Circuit determined the plan of distribution in *Kirschner* did not result in the debt instrument "being offered and sold to a broad segment of the public." Key factors in this determination were the prohibition on transfers to natural persons, the sophistication of those who would be lenders, and the consent rights of the administrative agent and the borrower.

There are numerous transactions in the municipal market wherein transfer is limited to sophisticated transferees, whether to "accredited investors" or "qualified institutional buyers"; however, it is not typically being driven by a loan-versus-security analysis but rather implementation of a conduit issuer's issuance guidelines or suitability concerns. From the perspective of an entity serving as a placement agent, however, the distinction could be very important. While outside legal opinions are not typically requested (and rarely, if ever, given) on the subject, in-house counsel has to address this issue frequently so it is important to keep the key factors in mind in structuring and documenting transactions. Drew notes in his column to avoid "securities-like terminology" but it may also be good practice to exclude "natural

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[6] Commercial intention weighs toward a "loan" and investment intention weighs toward a "security."

persons" from permitted transferees. And, should the avoidance of securities-like terms extend to the use of "accredited investor" and "qualified institutional buyer"?

A couple of final notes on this topic. First, I wouldn't place too much emphasis on the numerous references in the opinion to (and blessings of) the disclaimers used in both the Credit Agreement and the confidential information statement. The disclaimers were beneficial to the court in the analysis of determining the relationship between the lenders and the lead arrangers by emphasizing the requirement that each lender perform its own independent credit analysis. That said, it's nice to know disclaimers do serve a purpose in the right context.

Second, it was the fourth factor in the *Reves* analysis on which the court wanted the SEC to weigh in. That factor is whether "some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." The court relied on *Banco Espanol de Credito v Sec. Pac. Nat'l Bank* [7] to conclude the fourth factor was resolved in favor of loan treatment because (a) the loan was secured (presumably less risky) and (b) there exists sufficient bank regulatory policy and guidance with respect to participation by banks in syndicated loans. The Plaintiff argued that not all the lenders in the transaction were banks, rendering bank regulatory policy and guidelines insufficient to protect the other participants, which is the same argument put forth by the SEC in an amicus brief in the *Banco Espanol* proceeding in 1992. "We were unpersuaded then, and plaintiff offers no compelling reason to revisit that decision now," the court stated, and, in a footnote added "Nor does the SEC," referencing the declined invitation to the SEC to provide its views on the matter.

Closing Thoughts

I was saddened to hear of the passing of Robert Doty in April. The Bond Buyer referred to him as a "titan" of the municipal market and, by most remembrances, a passionate advocate regarding municipal disclosure and other matters affecting the municipal market and municipal issuers, in particular. I remember him as a tall, soft-spoken, gentleman who was respected and respectful. I did not always agree with Robert's positions, but I thoroughly enjoyed the discussion and debate.

And now, enjoy the rest of this edition of *The Bond Lawyer*.

[7] *Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992).

Federal Securities Law

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The summer quarter brought corporate guidance from the SEC and securities case law developments of direct interest to the municipal securities market. We also observed interesting follow-ons in ongoing SEC Enforcement matters.

SEC Finalizes Cybersecurity Disclosure Requirements for Public Companies – Relevant Guidance for the Municipal Market

An interesting, evolving trend in municipal market disclosure is the SEC's "nudge" to municipal securities participants to look to analogous SEC corporate guidance. In the absence of an update to the 1994 Interpretive Release, the SEC is using the corporate framework to convey disclosure concepts to the municipal market. In 2019, the SEC used a corporate framework to introduce the financial obligation reporting amendments to Rule 15c2-12. In its February 2020 Staff Legal Bulletin regarding the application of the antifraud provisions to statements by municipal issuers and obligated persons in the secondary market, the Staff stated its views regarding disclosure obligations of municipal issuers in the context of "entities whose securities are publicly traded" and suggested that municipal issuers disclose current information in a variety of ways "like public companies". In its COVID-19, May 2020 Statement, "The Importance of Disclosure for our Municipal Markets," the SEC Chair and Director of the Office of Municipal Securities followed the form and substance of a "Corporate Issuer Statement" on the same disclosure topic. At the May 2023 SEC Disclosure Conference, there was significant discussion about the interplay between corporate disclosure rules and municipal securities disclosure, including Regulation FD on the corporate side vs. voluntary disclosure for municipal bonds and potential rulemaking approaches under the Financial Data Transparency Act. Included in the Conference topic of "Broad Risks" was discussion of "Governance Risk – Cybersecurity."

On July 26, 2023, the SEC adopted cybersecurity disclosure rules for public companies. The new rules add an Item to Form 8-K (the corporate equivalent of municipal material event notices) which requires disclosure of material cybersecurity

incidents within four business days from the determination of materiality. The final rules also create a new item to Regulation S-K (the corporate equivalent of municipal primary disclosure and annual financial information reporting) concerning cybersecurity risk management, strategy and governance.

In describing these new rule concepts for reporting companies, the SEC's adopting release offers interesting, analogous insights for municipal issuers and obligated persons on (a) what the SEC believes constitutes a "cybersecurity incident", (b) what is the materiality threshold regarding such incidents, and (c) timing requirements for disclosing material cybersecurity incidents.

A "cybersecurity incident" means "an unauthorized occurrence, or a series of related unauthorized occurrences, on or conducted through a [public company's] information systems that jeopardizes the confidentiality, integrity, or availability of a [public company's] information systems or any information residing therein." The corporate bar advises that this new defined term hinges on the identification of an event that "jeopardizes" a public company's IT systems. Insofar as the adopting release emphasizes that the term "cybersecurity incident" in the final rules is to be "construed broadly", it is likely the SEC will take the broadest view of the term "jeopardize." Similar concepts of incident, aggregation of occurrences, and "jeopardize" may be relevant to a municipal issuer framing risk disclosure for a primary offering document or in evaluating a voluntary disclosure to the secondary market. (There is no Rule 15c2-12 event notice tied to cybersecurity incidents.)

Known well to municipal bond disclosure counsels and underwriter's counsels is the adopting release's discussion of materiality threshold. The SEC makes clear that traditional concepts of materiality apply in the context of a cybersecurity incident just like any other. Citing *TSC Industries, Inc. v. Northway, Inc.* and *Basic, Inc. v. Levinson,* among other cases (each of these recognized as key authorities in evaluating materiality in the municipal context):

"[I]nformation is material if 'there is a substantial likelihood that a reasonable shareholder would consider it important' in making an investment decision, or if it would have 'significantly altered the 'total mix' of information available.' 'Doubts as to the critical nature' of the relevant information should be 'resolved in favor of those the statute is designed to protect,' namely investors"

The adopting release goes on to state that companies should consider qualitative factors alongside quantitative factors in assessing materiality, noting:

“[M]ateriality analysis is not a mechanical exercise and not solely quantitative, but rather should take into consideration ‘all relevant facts and circumstances surrounding the cybersecurity incident, including both quantitative and qualitative factors”.

Noted that this is well-trodden materiality analysis for municipal bond, disclosure and underwriter’s counsels.

The new disclosure for public companies is required within four days after a company makes a determination that a cybersecurity incident is material. A new instruction to this new current reporting requirement of Form 8-K is also helpful analogous guidance to an issuer evaluating timing of a voluntary disclosure:

“[A public company’s] materiality determination regarding a cybersecurity incident must be made without unreasonable delay after discovery of the incident.”

In the adopting release, the SEC highlights its elimination of the “as soon as practicable” requirement in its proposed rule with the more favorable “without unreasonable delay” requirement in the final version, which it did to avoid public company’s rushing to make disclosure without sufficient information. However, the adopting release provides examples of unreasonable delays and, of direct relevance to the municipal market, advises that adhering to normal internal disclosure policies, procedures, and controls will suffice to demonstrate good faith compliance. Again, the relevant theme to municipal issuers being the fundamental importance of having disclosure policies and procedures in place that specifically address cybersecurity incidents.

Finally, the final rules create a new item to Regulation S-K (relevant to new offering disclosures, annual reporting, proxy statements, and other ongoing reporting) concerning disclosure of a public company’s cybersecurity risk management, strategy, and governance, each of which must be disclosed annually in a company’s 10-K. The new item provides a nonexclusive list of topics companies should address in describing their risk management processes, which may also provide helpful guidance to municipal issuers evaluating their primary disclosures on cybersecurity risk, including (i) whether and how any such processes have been integrated into the company’s overall risk management system or processes; (ii) whether the company engages assessors, consultants, auditors, or other third parties in connection with such processes; and (iii) whether the company has processes to oversee and identify such risks from cybersecurity threats associated with its use of any third-party service provider.

In sum, the new cybersecurity disclosure requirements for public companies – while not applicable to municipal securities – offer a disclosure framework familiar and useful to municipal issuers: applying much utilized, traditional materiality concepts and

underscoring the importance to an issuer of well documented disclosure policies, procedures, and controls that will demonstrate good faith on an issuer's behalf. This will minimize the SEC's using the benefit of hindsight to scrutinize an issuer's decisions regarding cybersecurity risk disclosure.

Case Law: Syndicated Loan vs. Security

On August 24, the Second Circuit issued its ruling in *Kirschner v. JP Morgan Chase Bank, N.A.* and other named institutions favorable to the banking industry, holding that the syndicated loan structure presented in the case was not a security. This case is discussed by Sandy MacLennan in her remarks above. The loan vs. security issue presents itself to many a municipal bond practitioner in the context of direct placements with banks and loan participations or loan syndications by banks purchasing municipal debt obligations. In the municipal securities context, one can assume that the SEC will be inclined to a broad interpretation of what constitutes a security under either the 1933 Act and the 1934 Act, and that the MSRB may be equally inclined to find a municipal security. (Neither agency weighed in on the *Kirschner* case).

Consequently, the securities law posture of the *Kirschner* case is of interest. Key to the decision is found in footnote 58 of the decision. The plaintiffs in *Kirschner* brought claims under the state-securities laws of various states. There was some stipulation or agreement among the parties that the U.S. Supreme Court's *Reves vs. Ernst & Young* test applied to state securities law claims. However, the *Reves* test is used to determine whether notes are "securities" under both the 1933 Act and the 1934 Act. The plaintiffs did not bring claims under either the 1933 Act or 1934 Act. The Second Circuit accepted the plaintiff's assertion that the *Reves* decision applies to claims under state-securities laws. The Second Circuit describes the *Reves* test as follows:

Under *Reves*, courts must apply a "family resemblance" test to determine whether a "note" is a "security." The test "begin[s] with a presumption that every note is a security." It then directs courts to examine four factors, each of which helps to uncover whether the note was issued in an investment context (and is thus a security) or in a consumer or commercial context (and is thus not a security). The four factors are:

1) "[T]he motivations that would prompt a reasonable seller and buyer to enter into" the transaction;
2) "[T]he plan of distribution of the instrument";
3) "[T]he reasonable expectations of the investing public"; and

4) "[W]hether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."

Most helpful to the municipal securities practitioner in delineating between loan vs. security may be the Second Circuit's discussion of the second factor on plan of distribution:

The second *Reves* factor requires us to "examine the plan of distribution of the instrument to determine whether it is an instrument in which there is common trading for speculation or investment." This factor weighs in favor of determining that a note is a security if it is "offered and sold to a broad segment of the public." This factor weighs against determining that a note is a security if there are limitations in place that "work[] to prevent the [notes] from being sold to the general public."

The pleaded facts do not plausibly suggest that the Notes were "offered and sold to a broad segment of the public." The Lead Arrangers offered the Notes *only* to sophisticated institutional entities, providing them with a Confidential Information Memorandum. JP Morgan then proceeded to allocate the Notes to *only* the sophisticated institutional entities that submitted "legally binding offer[s]."

This allocation process was not a "broad-based, unrestricted sale[] to the general investing public."

Plaintiff points to the presence of a secondary market as evidence that the Notes were "offered and sold to a broad segment of the public." But the restrictions on any assignment of the Notes rendered them unavailable to the general public. The Notes could not be assigned to a "natural person." Nor could they be assigned without prior written consent from *both* Millennium *and* JP Morgan Chase, acting in its capacity as Administrative Agent, unless an assignment was being made to a "Lender, an affiliate of a Lender or an approved fund." Nor could any assignment total [more][*sic*] than $1,000,000, unless it was to a "Lender, an affiliate of a Lender, or an Approved Fund or an assignment of the entire remaining amount of the assigning Lenders[']" allocation.

The *Kirschner* decision, while helpful to the banking industry, carries with it some cautionary notes. First, the court did not release a blanket opinion that no syndicated loan is ever a security. It only applied the *Reves* factors to the particular syndicated loan structure at issue. Second, the case involved claims made under state-securities laws, not under federal securities laws. States apply a variety of case law and administrative tests other than *Reves* (for example, the *Howey* test and even

broader tests such as a risk capital test) in evaluating whether an instrument or investment contract constitutes a security which may provide other avenues for state regulators or plaintiffs to challenge loan structures. It remains good practice in loan documentation to avoid securities-like terminology such as "investor," "investment," or "broker." And a structure or practice of syndicating loans to dozens of participants, rather than a small group of lenders, may remain subject to further claims under other state statute and case law tests and rules that securities are being offered.

Enforcement Updates

Some case follow-ons and SEC Enforcement notes from the summer months:

- Sterlington, LA Enforcement Action – on May 8, 2023, the United States District Court for the Western District of Louisiana entered a Consent Judgement, reported out publicly in July, in the matter of *SEC vs. Vern Breland*. Breland was the Mayor of Sterlington, Louisiana in the Sterlington enforcement action reported in previous issues of this publication. Breland consented to being permanently restrained and enjoined from (a) participating in municipal securities offerings, (b) participating in the preparation of any offering materials used in municipal securities offerings and (c) violating Section 10b and Rule 10b-5 of the Exchange Act and Section 17(a) of the Securities Act, as well as paying a civil penalty.

- Limited Offering Exemption Cases - on July 18, 2023, the SEC announced a seventh action against a firm for non-compliance with the Rule 15c2-12 limited offering exemption. In an administrative order, the Commission settled with Fifth Third Securities, Inc. In this no admit/no deny case, Fifth Third agreed to a cease and desist, censure, disgorgement, and a civil penalty.

- Off Channel Communications – of interest, in "admission settlements" with 11 broker dealer firms, the SEC brought charges for recordkeeping and failure to supervise violations:

"The SEC's investigation uncovered pervasive and longstanding "off-channel" communications at all 11 firms. As described in the SEC's orders, the firms admitted that from at least 2019, their employees often communicated through various messaging platforms on their personal devices, including iMessage, WhatsApp, and Signal, about the business of their employers. The firms did not maintain or preserve the substantial majority of these off-channel communications, in violation of the federal securities laws. By failing to maintain and preserve required records, certain of the firms likely deprived the Commission of these off-channel communications in

various SEC investigations. The failures involved employees at multiple levels of authority, including supervisors and senior executives."

While these communications cases are not unique to municipal securities *per se*, they highlight the broad reach of SEC Enforcement's investigatory and subpoena powers when it is seeking fact discovery in a case of alleged securities law violations, including in municipal securities matters.

From previous issues of this column, there are a number of enforcement cases in the "pipeline" involving issuers, issuer officials, underwriting firms and municipal advisors, or those acting as municipal advisors. Fall will likely bring some key developments.

The Tax Microphone

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Well, the summer of 2023 has now come and gone. As we contemplate the approach of the year-end and the start of 2024 (!), let's take in a couple of the (relatively few) tax law developments in the field of municipal finance that have transpired recently.

Update: Commentary on Proposed Section 6417 Regulations.

As I reported in my last column, the Department of Treasury and the Internal Revenue Service released a notice of proposed rulemaking (REG-101607-23) on June 14, 2023, offering guidance on the making of elections under the provisions of the Inflation Reduction Act of 2022 that permit certain tax-exempt entities, including state and local governmental entities and 501(c)(3) organizations, to claim refundable tax credits (also known as "direct-pay" credits or subsidies) for their capital investments in clean or renewable energy projects. This update isn't about any additional regulatory developments on the Section 6417 front, per se, but I want to call attention to the excellent commentary that NABL's leadership submitted to the IRS on August 14, 2023, regarding the proposed regulations. A copy of NABL's submission can be found at https://www.nabl.org/resources/comments-proposed-section-6417/.

NABL's commentary makes a broad survey of the proposed Section 6417 regulations and helpfully offers insight into certain aspects of the administrative construct that the government intends to use to deliver these valuable cash subsidies to eligible entities, particularly those aspects of administering the Section 6417 regime that could prove challenging to state and local governmental entities and 501(c)(3) organizations. For example, the NABL submission calls attention to the project registration process for capital investments that will give rise to Section 6417 payments, suggesting that the IRS should make a concerted effort to publicize the requirements for registration and even the existence of the registration portal itself, whenever it becomes accessible to users (as of the date of this column, the registration portal still has not gone live). NABL also makes a helpful and fundamental observation, which is that those in a position to claim Section 6417 subsidies can be

expected in many cases to want to use their attorneys, accountants, or financial advisors to handle project registrations, and so NABL encourages the regulators to ensure that appropriate access to the portal is afforded to authorized representatives.

NABL also points out, quite rightly, that the filing vehicles that will be used to actually capture the subsidy payments—namely IRS Forms 990-T and 3800—will be entirely alien to most state and local governmental entities, who typically are not required to file any federal tax returns or statements. Form 990-T, of course, is the return on which exempt organizations such as Section 501(c)(3) entities report unrelated business taxable income, and Form 3800 is used by federal taxpayers to claim general business credits. It is probably a bit of an understatement to say that these forms will present a square-peg-round-hole conundrum for eligible governmental entities that are eligible to claim Section 6417 credits, particularly in their current revisions, as they are not at all adapted for this purpose. Unless the IRS acts soon to make changes to these forms, we can reasonably anticipate a fair amount of unnecessary confusion.

Other useful points are covered in the NABL submission, including (i) comments on the so-called haircut methodology that will have to be employed to reduce the amount of the Section 6417 subsidy to be paid when the eligible project in question is financed in whole or in part with the proceeds of tax-exempt bonds, (ii) on the application of the prohibition of "federal guarantees" on such bonds under Code Section 149(b) and (iii) on the character of the subsidy payment as "proceeds" of such bonds when received from Uncle Sam (hint: they should <u>not</u> be treated as bond proceeds for any purpose of Sections 103 and 141-150 of the Code). But I will end this report on one other topic that could have an impact on the business planning and transactional approach that state and local governmental entities and 501(c)(3) organizations take to develop eligible clean energy projects—namely, the ability to use limited liability companies, partnerships or other types of pass-through entities to own and operate the projects without undercutting access to Section 6417 credits. As NABL points out, for a variety of state law and business reasons, governmental entities otherwise eligible to claim a Section 6417 credit may need or prefer to use a wholly-owned corporation or limited liability company to own and hold the renewable energy assets being developed. The same could be said of partnership structures as well.

Unfortunately, the proposed Section 6417 regulations, as currently drafted, fall short of the mark in this regard. In fact, this position on the part of the regulators, if it is intentional, seems to be something of a reversal from the helpful guidance that has been furnished in the bond area in recent years adopting an "aggregate" approach (in

contrast to an "entity" approach) for purposes such as figuring out whether the use of an LLC or a partnership gives rise to private business use under Section 141 of the Code (see, for example, Treasury Decision 9741 and the related revisions to Treasury Regulations Section 1.141-1(e) that were helpfully made in 2015) and would withhold the credit in many of these cases, for no particularly compelling policy reason. In my view, NABL correctly points out that Section 6417 subsidies should not be withheld when a state or local government entity or a 501(c)(3) chooses for its own good reasons to use a limited liability company or another wholly-owned corporate affiliate to hold title to an eligible project.

On this latter point, and in closing, I'll note that the comments of the American Hospital Association on the proposed Section 6417 regulations (you can read them at https://www.aha.org/lettercomment/2023-08-10-aha-comments-irs-elective-payment-applicable-credit-proposed-rule) go a step farther, stating that the rules as currently drafted would categorically prohibit subsidy elections for partnership structures and going on to assert that "[t]here was at least some expectation by the AHA . . . that the regulations would adopt an aggregate approach to the direct pay election to better facilitate the participation of tax-exempt and governmental entities in common industry partnership structures . . . ."

I, for one, agree with the AHA's position that it would make good sense from a policy viewpoint to apply an "aggregate" approach to the subsidy capture rules of Section 6417. This would permit eligible partners in a partnership to claim the direct-pay subsidies they would otherwise be in a position to claim if they directly owned their share of the eligible assets held by the partnership. The AHA makes a good point when it asserts that the adoption of such a sensible regulatory approach would significantly enhance the adoption of clean energy technologies in the marketplace.

Redux: Indiana Municipal Power Agency et al. v. U.S.

You might recall that a couple of issues back, I reported on the proceedings in the case of *Indiana Municipal Power Agency et al. v. United States*. If so, you might also recall that the case involves claims brought by IMPA and other Midwest public power agencies against the federal government centered around the less-than-controversial notion that the feds for a long time have been breaching a promise made to issuers of build America bonds ("BABs") by using budgetary sequestration in every year since 2013 to reduce the amount of the direct-pay subsidy available to BABs issuers under Section 1531 of the American Recovery and Reinvestment Act of 2009. And if you're with me this far, you might even remember that earlier this year the U.S.

Court of Appeals for the Federal Circuit had upheld a Court of Federal Claims decision rejecting the statutory and contract-based claims of IMPA and its co-claimants for restitution of the sequestered direct-pay subsidies with respect to their BABs.

Well, I can now report that IMPA and the other plaintiffs in the case recently filed a petition for a writ of certiorari to the Federal Circuit with the U.S. Supreme Court. This, notwithstanding that the Federal Circuit seems to have viewed the legal analysis supporting a rejection of IMPA's claims as something akin to an unobstructed lay-up shot on the basketball court. I can also report that on August 16, 2023, NABL joined a host of other membership organizations with ties to the municipal marketplace, including the Government Finance Officers Association, the National Association of Counties, the National League of Cities, and the National Association of College and University Business Officers, to file an amicus curiae brief in support of IMPA's appeal to the Supreme Court.

The amicus brief makes a number of points that are sympathetic to the plight of BABs issuers, who indeed have not received the full benefit of their statutory bargain as a result of the ongoing sequestration measures that have been imposed on them by the federal government. If the amicus submission is correct, and IMPA and its cohorts have been disappointed due to overreaching administrative interpretations of general spending legislation, it would follow that allowing the feds to renege on direct pay subsidy commitments would make federal-state cooperation harder, compromise "core state functions" that are deserving of constitutional protection and "allow unelected and unaccountable administrators" (also known as federal bean counters) to run roughshod over structural guardrails meant to benefit state and local governments. Come to think of it, all of these things are true even if the Federal Circuit's legal reasoning is correct and IMPA and its co-claimants don't have a legal leg to stand on. All of this suggests to me that if a "BABs version 2.0" should ever come to pass in a new statutory enactment, the issuers must be well and truly convinced that it is immunized against sequestration and other budgetary haircutting devices.

Private Letter Ruling 202306009

Finally, a brief summary of Private Letter Ruling 202306009, which surfaced earlier this year and came to my attention over the course of the summer. In the ruling, which has been characterized by one commentator as a "jigsaw puzzle with 400 pieces missing," the IRS revoked the Section 501(c)(3) determination of a nonprofit company whose mission was to furnish foster care services for children such as counseling,

training, and family placement and support services. The Service reasoned that the nonprofit's earnings inured to the benefit of the individual who founded the nonprofit, as well as the founder's spouse.

It appears from the ruling that at some point after the nonprofit was organized, the founder of the nonprofit and his spouse set up a for-profit company to provide corporate management services to the nonprofit, under terms set forth in a management agreement. Though it's not clear from the ruling what the initial term of the management agreement was (it did have an evergreen feature allowing for the term to be renewed unless either party were to opt out), it seems that the management company was to provide a range of the third-party corporate management services that an arrangement like this could be expected to cover, including the provision of senior management staffing for the nonprofit, budgeting, and financial reporting services, and the like. Compensation for services provided was based on a percentage of gross revenues, though it doesn't appear from the face of the ruling that the IRS took the position that the compensation was excessive or that the term of the agreement was overlong. Under the terms of the agreement, the nonprofit's board was to assess the management company's performance on an annual basis. I could not find a reference in the ruling's 27 pages to any rights of early termination that the nonprofit retained under the terms of the agreement, as, for example, for cause if the board were to determine in an annual review that the manager's performance had been unsatisfactory.

One thing that is apparent from the ruling is that, based on the facts as the IRS understood them (and bear in mind, not all of those facts are necessarily apparent to us, based on the considerable redactions in this jigsaw puzzle of a PLR), the IRS took the position that the management agreement was not an arm's length arrangement because it had not been competitively bid. It's also clear that the IRS was concerned that the nonprofit's interests were overly aligned with the manager's under the terms of the management agreement, which apparently signified to the IRS that the manager's strategic input to the nonprofit, if it were to stimulate revenue generation, would directly benefit the owners of the management company.

In one light, these factors seem like they could or should set off alarm bells for bond counsel who opine on qualified 501(c)(3) bond offering involving borrowers who have management contracts. 501(c)(3) management services arrangements themselves are not entirely unheard of. And, after all, there is no bright line rule in federal tax law that a management services contract must be let out for bidding before a management company is selected, in order to avoid jeopardizing the 501(c)(3) status

of the borrower. By the same token, there is no categorical prohibition on basing the compensation of a management services provider on a share of the gross revenues of the nonprofit.

It may be, however, that the unseen facts in this case, those that have been redacted out of public view, were determinative here. The manager's share of gross revenues could have been 85% for all we know. The agreement could have had a nominal term of 50 years, with no early termination rights on the part of the nonprofit. Those kinds of factors could make the Service's position in the ruling quite compelling. We cannot know. But we can see that competitive bidding will be a crucial factor for the IRS when it scrutinizes these types of arrangements, particularly when "insiders" are involved. Term and termination provisions will also be matters of interest when third-party management agreements are scrutinized. It's probably fair to say that we already knew that we should carefully these factors when we conduct our diligence in transactions involving corporate management arrangements for 501(c)(3) borrowers, but PLR 202306009 is a good reminder of why these issues matter to bond practitioners. Those of you who are interested in reading the ruling can find it at www.irs.gov/pub/irs-wd/202306009.pdf.

Thank you for sticking with me to the end of this column, and best wishes to all of you for the rest of 2023!